

Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:CORP:BO6 – PLR-147077-03

Date:

December 08, 2003

In Re:

LEGEND

Distributing =

Controlled 1 =

Controlled 1 Sub =

Controlled 2 =

State AA =

Date 1 =

Date 2 =

Date 3 =

Individual =

PLR-147077-03

Shareholder A =

Shareholder B =

Shareholder C =

Business D =

Business E =

Business F =

Operation =

Property =

Partnership =

g =

h =

i =

\$j =

\$k =

m =

n% =

q% =

Dear Mr.

This letter responds to a letter dated August 7, 2003, submitted on your behalf by your authorized representative, requesting rulings on the federal income tax

PLR-147077-03

consequences of a proposed transaction. Additional information was submitted in a letters dated October 20, 2003 and December 4, 2003. The information submitted for consideration is summarized below.

SUMMARY OF FACTS

Distributing, a calendar year taxpayer, is a State AA corporation that was incorporated on Date 1 by Individual. Distributing is engaged in Business D both directly and indirectly through its subsidiaries and on Date 2 elected to be taxed as an S corporation, within the meaning of Section 1361(a) of the Internal Revenue Code. Distributing maintains its books using the accrual method of accounting.

Distributing has one class of stock outstanding: its voting common stock ("Distributing Common Stock"). Distributing has issued and outstanding g shares of Distributing Common Stock, which are owned equally by Shareholder A, Shareholder B, and Shareholder C (each owns h shares representing n% of the outstanding Distributing Common Stock). Shareholder A, Shareholder B, and Shareholder C are siblings and are children of Individual. Shareholder A is the Director of Distributing. Individual is the President of Distributing, but owns no stock in Distributing.

On Date 3, Distributing formed Controlled 1 Sub and Controlled 2, both State AA corporations, and filed the election under Section 1361(b)(3) to treat both Controlled 1 Sub and Controlled 2 as qualified subchapter S subsidiaries ("QSubs"). As a result, Controlled 1 Sub and Controlled 2 have been considered "disregarded entities" for federal income tax purposes since their respective formations and have not filed federal income tax returns. Their income and expenses have been reported on Distributing's return.

Controlled 1 Sub has one class of stock outstanding: its voting common stock ("Controlled 1 Sub Common Stock"). Controlled 1 Sub has issued and outstanding i shares of Controlled 1 Sub Common Stock, all of which is owned by Distributing. Controlled 1 Sub is engaged in Business E. Shareholder B is the President and Director of Controlled 1 Sub.

Controlled 2 has one class of stock outstanding: its voting common stock ("Controlled 2 Common Stock"). Controlled 2 has issued and outstanding i shares of Controlled 2 Common Stock, all of which is owned by Distributing. Controlled 2 is engaged in Business F. Shareholder C is the President and Director of Controlled 2.

PLR-147077-03

Financial information has been received that indicates that Business D, Business E, and Business F have had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past 5 years.

Controlled 1 will be formed by Distributing as a State AA corporation to facilitate the Proposed Transaction (defined below). Controlled 1 will have one class of stock outstanding: its voting common stock ("Controlled 1 Common Stock"). Controlled 1 will have issued and outstanding i shares of Controlled 1 Common Stock, all of which will be owned by Distributing prior to the Distributions (defined below). Controlled 1 will be a calendar year taxpayer and will maintain its books using the accrual method of accounting.

PROPOSED TRANSACTION

Serious disputes have arisen among the Distributing shareholders, which have adversely affected the business operations of Distributing, Controlled 1 Sub and Controlled 2. In order to alleviate the problems caused by the disputes among the shareholders, and pursuant to the Agreement and Plan of Corporate Separation (the "Agreement"), the following steps are proposed (collectively, the "Proposed Transaction"):

- (i) Distributing will form Controlled 1, and will contribute all of the stock of Controlled 1 Sub, Property, its q% interest in Partnership, and cash to Controlled 1 in exchange for all of the stock of Controlled 1.
- (ii) Distributing will contribute cash to Controlled 2 to equalize values.
- (iii) Distributing will distribute all of the stock of Controlled 1 to Shareholder B in exchange for all of the Distributing stock owned by Shareholder B ("Distribution 1").
- (iv) Distributing will distribute all of the stock of Controlled 2 to Shareholder C in exchange for all of the Distributing stock owned by Shareholder C ("Distribution 2") (Distributing 1 and Distributing 2 shall be hereinafter referred to, collectively, as the "Distributions").
- (v) Following the Distributions, Controlled 1 and Controlled 2 will each elect to be treated as an S Corporation pursuant to Section 1362(a). Controlled 1 will then elect to treat Controlled 1 Sub as a qualified subchapter S subsidiary pursuant to Section 1361(b)(3)(B)(ii).

PLR-147077-03

As a result of the Proposed Transaction, Shareholder A will own 100% of the stock of Distributing, Shareholder B will own 100% of the stock of Controlled 1, and Shareholder C will own 100% of the stock of Controlled 2. There will be no cross-ownership of stock following the Proposed Transaction, and no agreements or arrangements will exist to give any shareholder a right to acquire an interest in any other corporation.

On or prior to the completion of the Proposed Transaction, and pursuant to the Agreement, Distributing, Controlled 1 and Controlled 2 will each transfer \$j to an interest-bearing account established as a trust for the benefit of Distributing, Controlled 1, and Controlled 2 for the sole purpose of funding contingent liability claims for work performed by Distributing with respect to Operation, an aspect of Distributing's Business D, for periods prior to the Proposed Transaction (the "Claim Account"). The initial trustee of the Claim Account will be Individual. Upon Individual's resignation, inability, or refusal to act as trustee, the shareholders will upon unanimous consent appoint a third party trustee. If at any time the total funds in the Claim Account are less than \$k, Distributing, Controlled 1, and Controlled 2 are required to make additional deposits. The Claim Account will generally terminate m years after the completion date of the Proposed Transaction. However, in the event there are pending claims at the end of the aforementioned m-year period, the Claim Account will remain open until these claims are settled. Upon termination of the Claim Account, all remaining funds in the Claim Account will be distributed equally to Distributing, Controlled 1, and Controlled 2.

REPRESENTATIONS

The following representations have been made in connection with the Proposed Transaction:

- (a) The fair market value of the stock of Controlled 1 and Controlled 2 to be received by Shareholder B and Shareholder C, respectively, will be approximately equal to the fair market value of the stock of Distributing surrendered by each of Shareholder B and Shareholder C in the exchanges.
- (b) No part of the consideration to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than as that of a shareholder of Distributing.
- (c) The five years of financial information submitted on behalf of Distributing, Controlled 1 Sub, and Controlled 2 is representative of the corporations' present operation, and with regard to such corporations, there have been no substantial operational changes since the date of the last financial statement submitted.

PLR-147077-03

- (d) The gross assets of the trades or businesses that will be relied upon by Distributing, Controlled 1 and Controlled 2 to satisfy the active trade or business requirement of Section 355(b) will, in the aggregate, have a fair market value that is not less than five percent of the total fair market value of the gross assets of the company directly operating such trades or businesses.
- (e) Following the Proposed Transaction, Distributing, Controlled 1 and Controlled 2 will each continue, independently and with separate employees, the active conduct of its share of all the integrated activities of each business conducted by Distributing, Controlled 1 Sub, and Controlled 2 prior to the consummation of the Proposed Transaction.
- (f) The Distributions will be carried out for the following business purpose: to enhance the success of each business of Distributing, Controlled 1, and Controlled 2 by enabling the corporations to resolve management problems that have arisen and are exacerbated by the operation of the three businesses under the current structure. The Distributions are motivated, in whole or substantial part, by this corporate business purpose.
- (g) Distributing is an S corporation (within the meaning of Section 1361(a)). Controlled 1 and Controlled 2 will each elect to be an S corporation pursuant to Section 1362(a), and Controlled 1 will elect to treat Controlled 1 Sub as a QSub pursuant to Section 1361(b)(3) on the first available date after the Distributions, and there is no plan or intent to revoke or otherwise terminate the S corporation election of Distributing, Controlled 1, or Controlled 2.
- (h) There is no plan or intention by the shareholders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in Distributing, Controlled 1, or Controlled 2 after the Proposed Transaction.
- (i) There is no plan or intention by Distributing, Controlled 1, or Controlled 2, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the Proposed Transaction.
- (j) There is no plan or intention to liquidate Distributing, Controlled 1, or Controlled 2, to merge any of these corporations with any other corporation, or to sell or otherwise dispose of the assets of any of these corporations after the Proposed Transaction, except in the ordinary course of business.
- (k) The total adjusted bases and the fair market value of the assets to be transferred to Controlled 1 and Controlled 2 by Distributing each equals or exceeds the sum

PLR-147077-03

of the liabilities assumed (as determined under Section 357(d)) by Controlled 1 and Controlled 2.

- (l) The liabilities assumed (as determined under Section 357(d)) in the Proposed Transaction were incurred in the ordinary course of business and are associated with the assets being transferred.
- (m) No investment tax credit under the Internal Revenue Code has been, or will be, claimed with respect to any of the assets of the Controlled 1 Sub or Controlled 2 business being transferred by Distributing to Controlled 1, and Controlled 2, respectively.
- (n) Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.
- (o) No intercorporate debt will exist between Distributing and Controlled 1, Controlled 1 Sub, or Controlled 2, or between Controlled 1 Sub and Controlled 2 or between Controlled 1 and Controlled 2 at the time of, or subsequent to, the Distributions, except for obligations to fund the Claim Account.
- (p) Payments made in connection with all continuing transactions, if any, among Distributing, Controlled 1 and Controlled 2 will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length
- (q) No parties to the Proposed Transaction are investment companies as defined in Section 368(a)(2)(F)(iii) and (iv) .
- (r) Distributing, Controlled 1, Controlled 2, and the Distributing shareholders will each pay their own expenses, if any, incurred in connection with the Proposed Transaction.
- (s) The cash and investment assets held by Distributing and to be held by Controlled 1 and Controlled 2 are related to the reasonable needs of the conduct of the active trade or business of each corporation or to equalize values.
- (t) The Distributions are not part of a plan or series of related transactions (within the meaning of Section 355(e)) pursuant to which one or more persons will acquire, directly or indirectly, stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote of either Distributing, Controlled 1, or Controlled 2 or stock possessing 50 percent or more of the total value of all classes of stock of either Distributing, Controlled 1, or Controlled 2.

PLR-147077-03

- (u) For purposes of Section 355(d), immediately after the Distributions, no person (determined after applying Section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in Section 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the distribution date.

For purposes of Section 355(d), immediately after the Distributions, no person (determined after applying Section 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote of either Controlled 1 or Controlled 2, or 50 percent or more of the total value of all classes of stock of either Controlled 1 or Controlled 2, that was either (i) acquired by purchase (as defined in Section 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the distribution date, or (ii) attributable to distributions on Distributing stock that was acquired by purchase (as defined in Section 355(d)(5) and (8)) during the five-year period (determined after applying Section 355(d)(6)) ending on the distribution date.

RULINGS

Based solely on the information submitted and on the representations set forth above, we rule as follows:

- (1) Distributing's contribution of all of its Controlled 1 Sub stock to Controlled 1 will cause the termination of the QSub election of Controlled 1 Sub because Controlled 1 Sub will cease to be a wholly owned subsidiary of an S corporation. Because Controlled 1 Sub is a QSub of Distributing before Distribution 1, and Controlled 1 will elect to be an S corporation and elect to treat Controlled 1 Sub as a QSub of Controlled 1 with both elections to be effective on the first available date after Distribution 1, Controlled 1 Sub will not be treated as a separate corporation before or after Distribution. (Section 1.1361-5(b)(3), Example (9)).
- (2) Distributing's distribution of all of its Controlled 2 stock to Shareholder C will cause a termination of the QSub election of Controlled 2 because Controlled 2 will cease to be a wholly owned subsidiary of an S corporation. As a result of the termination, Controlled 2 will be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the distribution of the Controlled 2 stock by Distributing. (Section 1.1361-5(b)(1)(i)).

PLR-147077-03

- (3) The transfer by Distributing of assets to Controlled 1 solely in exchange for all of the common stock of Controlled 1 and the assumption of related liabilities by Controlled 1 followed by the distribution by Distributing of all of its Controlled 1 stock to Shareholder B solely in exchange for all of the Distributing Common Stock owned by Shareholder B, will qualify as a reorganization within the meaning of Section 368(a)(1)(D). Distributing and Controlled 1 will each be a "party to a reorganization" within the meaning of Section 368(b).
- (4) The transfer by Distributing of assets to Controlled 2 solely in exchange for all of the common stock of Controlled 2 and the assumption of related liabilities by Controlled 2 followed by the distribution by Distributing of all of its Controlled 2 stock to Shareholder C solely in exchange for all of the Distributing Common Stock owned by Shareholder C, will qualify as a reorganization within the meaning of Section 368(a)(1)(D). Distributing and Controlled 2 will each be a "party to a reorganization" within the meaning of Section 368(b).
- (5) No gain or loss will be recognized by Distributing on its transfer of assets to Controlled 1 in exchange for common stock of Controlled 1 and the assumption of related liabilities. (Sections 361(a) and 357(a)).
- (6) No gain or loss will be recognized by Distributing on its transfer of assets to Controlled 2 in exchange for common stock of Controlled 2 and the assumption of related liabilities. (Sections 361(a) and 357(a)).
- (7) No income, gain or loss will be recognized by Controlled 1 upon the receipt of the assets from Distributing in exchange for all of the common stock of Controlled 1 and the assumption of related liabilities. (Section 1032(a)).
- (8) No income, gain or loss will be recognized by Controlled 2 upon the receipt of the assets from Distributing in exchange for all of the common stock of Controlled 2 and the assumption of related liabilities. (Section 1032(a)).
- (9) The basis of the assets to be received by Controlled 1 will be the same as the basis of such assets in the hands of Distributing immediately prior to the transfer to Controlled 1. (Section 362(b)).
- (10) The basis of the assets to be received by Controlled 2 will be the same as the basis of such assets in the hands of Distributing immediately prior to the transfer to Controlled 2. (Section 362(b)).

PLR-147077-03

- (11) The holding period of the Distributing assets to be received by Controlled 1 will include the period during which such assets were held by Distributing. (Section 1223(2)).
- (12) The holding period of the Distributing assets to be received by Controlled 2 will include the period during which such assets were held by Distributing. (Section 1223(2)).
- (13) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder B upon its receipt of the stock of Controlled 1 in exchange for all its stock in Distributing. (Section 355(a)(1)).
- (14) No gain or loss will be recognized by (and no amount will be included in the income of) Shareholder C upon its receipt of the stock of Controlled 2 in exchange for all its stock in Distributing. (Section 355(a)(1)).
- (15) No income, gain or loss will be recognized by Distributing upon the distribution of all of the stock of Controlled 1. (Section 361(c)(1)).
- (16) No income, gain or loss will be recognized by Distributing upon the distribution of all of the stock of Controlled 2. (Section 361(c)(1)).
- (17) The basis of the stock of Controlled 1 in the hands of Shareholder B will be the same as the basis of the Distributing stock exchanged therefor. (Section 358(a)(1)).
- (18) The basis of the stock of Controlled 2 in the hands of Shareholder C will be the same as the basis of the Distributing stock exchanged therefor. (Section 358(a)(1)).
- (19) The holding period of the stock of Controlled 1 to be received by Shareholder B will include the holding period of Shareholder B's stock in Distributing, provided that such shares of Distributing stock were held as a capital asset on the date of the Distributions. (Section 1223(1)).
- (20) The holding period of the stock of Controlled 2 to be received by Shareholder C will include the holding period of Shareholder C's stock in Distributing, provided that such shares of Distributing stock were held as a capital asset on the date of the Distributions. (Section 1223(1)).

PLR-147077-03

- (21) As provided in Section 312(h), proper allocation of earnings and profits among Distributing, Controlled 1 and Controlled 2 will be made in accordance with Treas. Reg. Section 1.312-10(a).
- (22) Distributing's accumulated adjustments account (AAA) immediately before the Proposed Transaction will be allocated among Distributing, Controlled 1, and Controlled 2 in a manner similar to the manner in which Distributing's earnings and profits will be allocated under Section 312(h) and Treas. Reg. Section 1.1368-2(d)(3).
- (23) Distributing's momentary ownership of the stock of Controlled 1, as part of the reorganization under Section 368(a)(1)(D), will not cause Controlled 1 to have an ineligible shareholder for any portion of its first taxable year under Section 1361(b)(1)(B). If Controlled 1 otherwise meets the requirements of a small business corporation under Section 1361, Controlled 1 will be eligible to make a subchapter S election under Section 1362(a) for its first taxable year. Additionally, if Controlled 1 Sub otherwise meets the requirements of a QSub, Controlled 1 will be eligible to make a QSub election for Controlled 1 Sub under Section 1361(b)(3), provided such election is made effective immediately following the termination of Controlled 1 Sub's original QSub election.
- (24) Distributing's momentary ownership of the stock of Controlled 2, as part of the reorganization under Section 368(a)(1)(D), will not cause Controlled 2 to have an ineligible shareholder for any portion of its first taxable year under Section 1361(b)(1)(B). If Controlled 2 otherwise meets the requirements of a small business corporation under Section 1361, Controlled 2 will be eligible to make a subchapter S election under Section 1362(a) for its first taxable year, provided such election is made effective immediately following the termination of Controlled 2's original QSub election.

CAVEAT

No opinion is expressed about the tax treatment of the proposed transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the proposed transaction that are not specifically covered by the above rulings.

PROCEDURAL STATEMENTS

PLR-147077-03

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to the federal income tax return, of each taxpayer involved, regarding the taxable year in which the transaction is consummated.

Pursuant to a power of attorney on file in this office, we have sent copies of this letter to your authorized representatives.

Sincerely yours,

Steven J. Hankin

Steven J. Hankin
Senior Technician Reviewer
Branch 6
Office of Associate Chief Counsel
(Corporate)

cc: